

age of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income," "net earnings," or "net profits."

The term "debt" as used in section 26 (c) (2) does not include an obligation of the corporation to a shareholder, as such, as distinguished from a creditor. Accordingly, amounts paid into, or set aside for, a sinking fund by a corporation for the retirement of preferred stock, pursuant to the terms of an agreement underlying the preferred stock issue, shall not be considered as set aside for discharge of a debt. An indebtedness evidenced by bonds or other similar obligations issued by a corporation is incurred as of the date such obligations are issued, and the amount of such indebtedness is the amount represented by the face value of the obligations. For the purpose of this article a bond or other similar obligation is not issued until it is executed and delivered to a person who holds it as a debt of the corporation. Bonds issued after April 30, 1936, in exchange in refunding a preexisting issue represents debts incurred after April 30, 1936, within the meaning of section 26 (c) (2).

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ART. 26-4. DEFICIT CREDIT. [As added by T. D. 5263, *supra*].—Section 26 (f) is designed to be used particularly in those cases where the surtax on undistributed profits can not be avoided because the corporation has adjusted net income but has no accumulated earnings and profits at the beginning of the year and no earnings and profits of the taxable year on account of certain unallowable deductions, such as capital losses. In such a case a credit is allowed in the amount by which the adjusted net income exceeds the sum of the earnings and profits, if any, accumulated after February 28, 1913 (as of the beginning of the taxable year), and those of the taxable year, computed as of the close of such year, without regard to distributions made during the year, or to the amount of the surtax on undistributed profits imposed under section 14, the graduated income tax or surtax imposed under section 102, the tax on citizens and corporations of certain foreign countries imposed under section 103, or the surtax on personal holding companies imposed under section 351, for the taxable year. In computing earnings and profits as of the beginning of the taxable year accumulated after February 28, 1913, the taxes just mentioned for any previous taxable year are to be deducted only as computed under the amendments provided by section 501 of the Revenue Act of 1942. If there is a deficit in the accumulated earnings and profits as of the beginning of the taxable year, or for the taxable year, such deficit shall not be taken into consideration in determining the credit allowable under section 26 (f), and in such a case the earnings and profits as of the beginning of the taxable year, or the

earnings and profits of the taxable year, shall be considered as zero.

The application of the provisions of section 26 (f) may be illustrated by the following examples:

Example (1). The M Corporation on the accrual basis for the calendar year 1936 had a gross income of \$300,000, miscellaneous deductions of \$106,000, capital losses of \$92,000 of which only \$2,000 were deductible due to the provisions of section 117 (d), and a normal tax liability under section 13 of \$28,840. Its adjusted net income was therefore \$171,160 (\$300,000 less \$106,000 less \$2,000 less \$28,840) while its earnings and profits of the taxable year computed after deducting the normal tax imposed by section 13 for such year but without diminution by the amount of the tax imposed for such year by section 14, 102, 103, or 351, were \$73,160 (\$300,000 less \$106,000 less \$92,000 less \$28,840). Assuming that the corporation had no accumulated earnings and profits as of December 31, 1935, it is allowed, in computing its undistributed net income subject to tax under section 14, a credit under section 26 (f) of \$98,000, the amount by which the adjusted net income of \$171,160 exceeds the earnings and profits of the taxable year.

Example (2). If in the above example there was a contract in existence prior to May 1, 1936, under which the M Corporation could not distribute dividends in excess of \$150,000 during the calendar year 1936, section 26 (c) (1) is applicable and allows a credit of \$98,000, namely, an amount equal to the excess of the adjusted net income, \$171,160, over the aggregate of the amounts which can be distributed

within the taxable year as dividends, \$73,160. Accordingly, the credit allowance under section 26 (f) is inapplicable.

Example (3). Assume in example (1) that the M Corporation had a deficit of \$20,000 in accumulated earnings and profits as of December 31, 1935, and that the State law prohibited dividend distributions during the existence of a deficit in accumulated earnings and profits. In addition to the deficit credit of \$98,000 provided in section 26 (f), the M Corporation, under paragraph (3) of section 26 (c) is allowed a credit of \$20,000, the amount of the deficit in accumulated earnings and profits as of December 31, 1935.